



VALUE CREATION LAB

A&M'S VALSOURCE: PUTTING A VALUE ON COMPLEX FINANCIAL INSTRUMENTS

BY WILLIAM J. HOLSTEIN

One major challenge in the financial and energy sectors is establishing a fair market valuation for assets such as petroleum and natural gas that change in value each day. It is particularly crucial to get the valuations right because of increasing reporting requirements imposed by the Dodd-Frank Act of 2010 and because the long-term compensation of many energy sector executives is linked to the profit margins achieved on those products.



Bob Sparger, Senior VP and Chief Accounting Officer, Targa Resources
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The way that Targa Resources Corp. manages the problem is revealing. Targa, one of the largest independent midstream energy companies in North America, based in Houston, relies on A&M ValSource, an offering of Alvarez & Marsal Valuation Services, to help it manage the complexity. Here are excerpts from an interview with Bob Sparger, Senior VP and Chief Accounting Officer of Targa Resources.

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- Bob Sparger

Q. In view of all the upheaval in energy markets, it would seem that your ability to understand the cost structure of all these different products would be critical. Is that right?

A. That's absolutely correct. It's a margin business. Your margins are going to be the spread between what you buy and sell, factoring in the cost of processing. For companies like Targa, where we own gas processing facilities, we generally get a percent of the proceeds or a percent of the liquids for what we do.

Q. Another source of complexity is that the compensation of your executives is linked to the profits you achieve, right?

A. Yes, we are required to do a number of very complex financial calculations tied to our long-term incentive plan. What the team at A&M do, and they've done it for a long time, are Monte Carlo simulations of the value of restricted stock and restricted units in the MLP that are granted. Monte Carlo simulations are ways of calculating the odds when there are numerous unpredictable factors at work. The people at A&M are truly experts at that. Chandu Chilakapati, who is the managing director, can explain all this in a way that the layman can actually understand.

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Q. Do you also use A&M to keep track of derivative positions you take to hedge the value of some of your products?

A. Yes, the other thing we have A&M do is our quarterly derivatives valuation. Our derivatives program, as described in our 10-Q and 10-K filings to the Securities and Exchange Commission, is straightforward. The percentage of proceeds or a portion of the final product we get as a result of processing gas, we call that equity production. We hedge a fairly significant percentage of that equity production.

Under the accounting rules, we have to revalue those quarterly. I could do that in-house, but I see no reason to do it in-house. Why not use an expert who really understands derivatives like the A&M team do? That way, I don't need to keep that mathematical expertise in-house on our accounting staff. Secondly, from an internal control perspective, I would much rather have an independent third party doing those calculations because no one can say my accounting group manipulated any numbers to get to a desired result. That is a Sarbanes-Oxley type of internal control.

Q. What about your disclosures to the SEC?

A. We file both 10-Ks and 10-Qs. Within them, there is a section called "management discussion and analysis of the results of operations." We are required to give some disclosure about the risks we have for credit and so forth. Within that, we report our derivatives and we show our positions and fair values at the end of a particular quarter or year. We do a similar disclosure in the footnotes to the financial statements. A&M does the valuation and supports our hedge accounting and disclosures process. They are critical for us to be able to do that. If we didn't use A&M, we'd have to do all that math ourselves.



Chandu Chilakapati, Managing Director of A&M Valuation Services, Houston

To meet our schedules, it needs to be done by the 15th of the month following the end of a quarter. They can get it done faster than I can and still feel comfortable that the numbers are reasonable. They have knowledge and expertise that I don't want to try to maintain it in-house. The fact that they are a third party doing it for me, from a controls perspective, is really positive. I can point out to my auditor, that I am using a third party. Chandu is really good at answering Auditor questions. We've never had an issue with our auditors over any of the work that A&M has done for us. In addition to the support on hedge accounting and related disclosures, Chandu and his team also provide us with Dodd-Frank inception valuation reports so we can meet of reporting requirement as a derivatives end-user.



A&M's Valuation Services help companies move beyond compliance to competitiveness.

Q. What is it that is special or unique about the service that A&M provides you?

A. What's attractive about A&M is the intellectual capital that sits with Chandu and his team, to build the models, to make sure they work, and to make sure they don't generate abnormal or bad results. We're buying brainpower. We have had situations where, off cycle, we needed to revalue everything. We needed Chandu and his team to do another set of specialized calculations. We can pick up the phone and tell them what we need and they find a way to do it. That's priceless. It's really driven by the relationship. If they run into a complex situation, they will sit down and work through it because they really care about meeting the needs of their clients.

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Targa Resources Corp. is one of the largest independent midstream energy companies in North America.

Q. Can what A&M does for you be replicated more broadly in the energy industry?

A. If there's an energy company out there that's got production and got commodities that they are actively trading for their own account, Chandu and their guys can do the math for them and provide them with their position reports as well as support their hedge accounting and disclosure processes. Likewise for share-based valuations and reporting.

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